Profit Pressures on the Big Law Firms

Merrill Lynch's Latest Bombshell for Bankers

International Harvester's Last Chance

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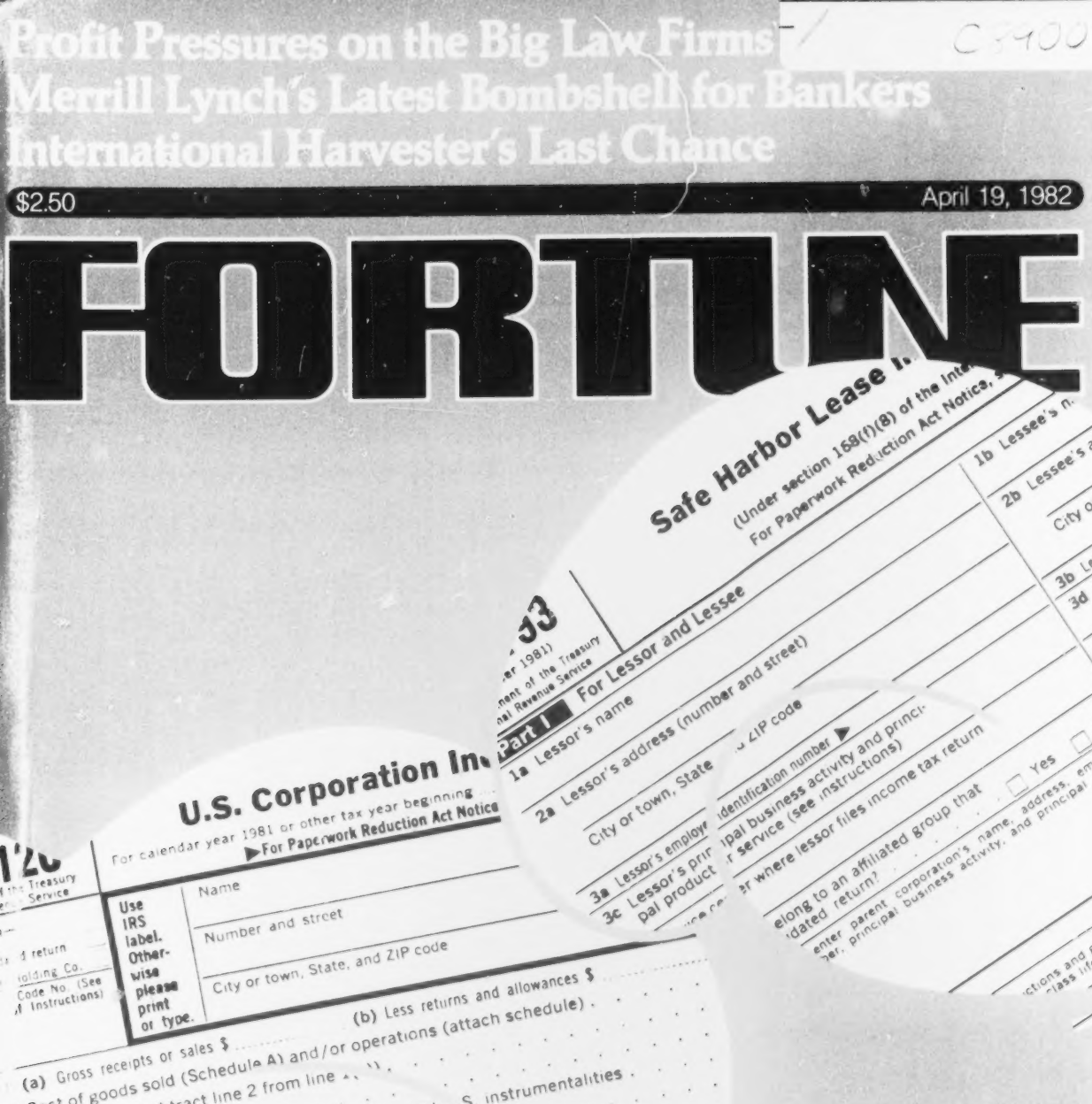

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The boxing gloves on the cover—designed by art director Ronald N. Campbell—suggest the spirited scrapping between businesses defending their tax benefits. For a report from ringside, see page 58.

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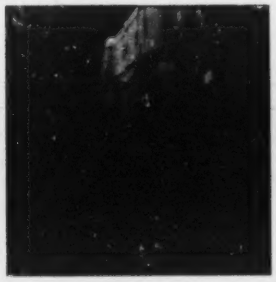

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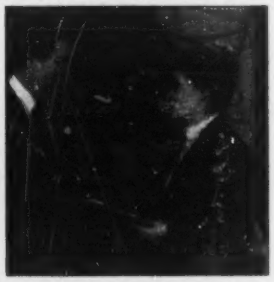

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CHEMICALS

Dow Plans to Keep Growing in Europe

The European chemical industry is troubled with excess capacity and shrunken profits, but one company remains undismayed.

by ROBERT BALL

In the European chemical industry these days, happiness is breaking even. The past two years have been the worst since the recovery from the ruin of World War II. Among the companies losing money are not only chronic problem cases like Montedison and Rhône-Poulenc, but also the Dutch Akzo Group and the chemical divisions of Shell and British Petroleum. Most of the rest, including Imperial Chemical Industries and the leading West German companies, have reported sharply reduced earnings.

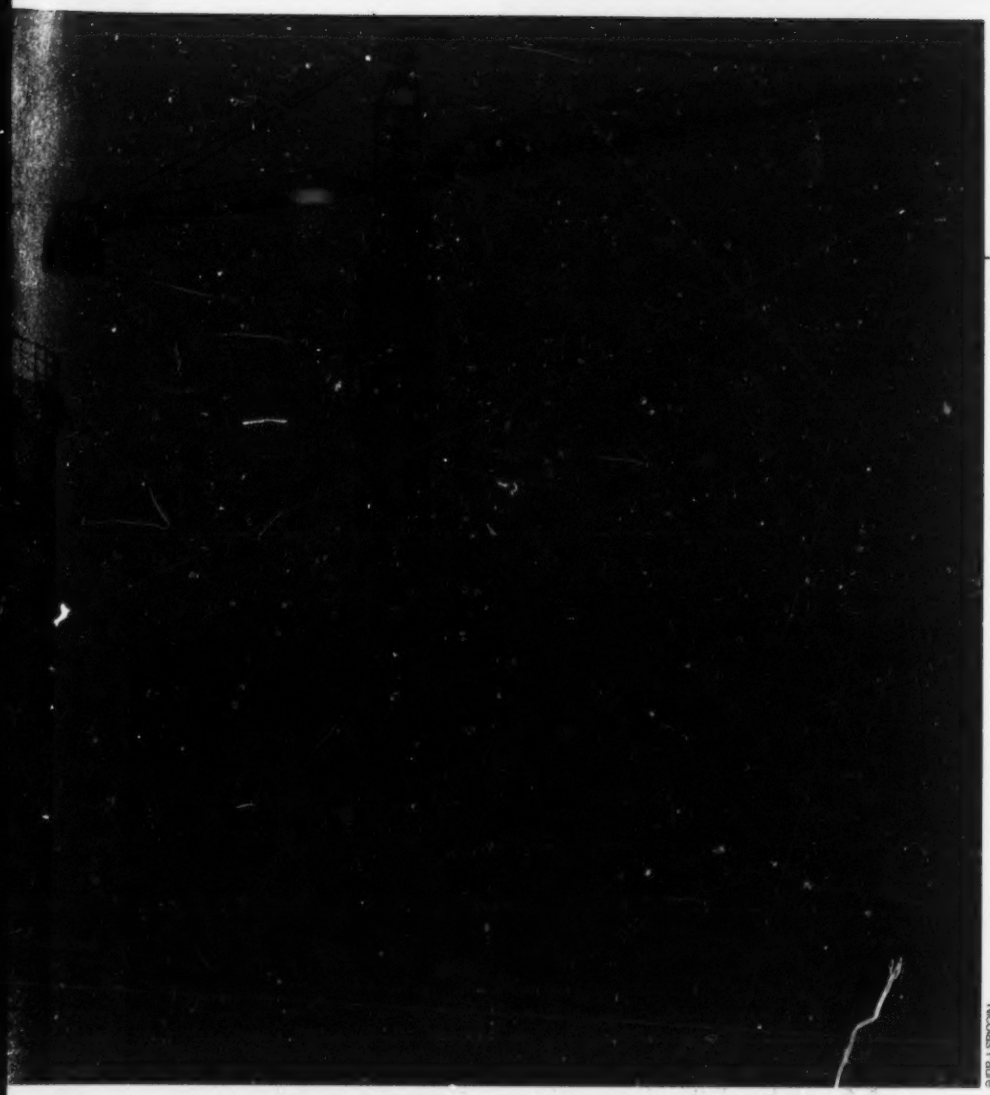
Bulk chemicals, plastics, and synthetic fibers have all been money losers, with industry losses on plastics alone reportedly running at $200 million a month. Overcapacity weighs heavily on prices. Western Europe has enough capacity to turn out 18 million metric tons a year of ethylene—the basic petrochemical building block—in a market currently absorbing only about 13 million tons. Moreover, Eastern Europe, frantic for hard currency, is pushing its products West at almost any price, while just over the horizon loom the new Mideast petrochemical plants that will get their feedstock virtually for nothing.

A pattern of retreat

Add lofty labor costs to this picture and it's no wonder American chemical companies have been cutting back in Europe. Monsanto and Union Carbide have sold off substantial European operations and Tenneco is seeking a buyer for a British subsidiary. Gulf Oil searched unsuccessfully for someone to buy its European chemical plants, and will now simply close them down.

One U.S. chemical company, however, remains undismayed, even confident, about the prospects in Europe—Dow Chemical of Midland, Michigan. Over the years the European branch has become a huge and fully integrated chemical company itself. Its sales of $3.3 billion last year accounted for 28% of the parent company's total worldwide sales. (See chart, page 76.) In a normal year Dow Chemical Europe also contributes a hefty share of overall corporate profits.

Last year was not normal, though Dow Europe did manage the impressive feat of making a profit on plastics. Operating income, $135 million, was less than half the previous year's, and the $80 million contributed to corporate profits came to not much more than a quarter of the 1980 figure. Yet Dow continues to invest $200 mil-



Nicolas Faure

These two new storage tanks at the Dow Europe complex at Terneuzen in the Netherlands will each hold 50,000 cubic meters of LPG—liquefied petroleum gas. It's used as a feedstock in the production of petrochemicals.

lion to $300 million in new money in Europe every year, plus a European R&D budget approaching $100 million annually. Is the company just being stubborn, or does it know something others don't?

What Dow Europe President Frank Popoff and his lieutenants think they know is that lean and nimble companies can still make good money in the European chemical business. The winners will be companies that keep costs under control and grab the growth markets—in pharmaceuticals, in plastic packaging (as the energy-intensive tin can and glass bottle disappear), in automobiles (weight-saving plastics), in insulation, in substitutes for pulp-based paper (an energy gobbler), and in sophisticated agricultural chemicals. Most of the growth, then, will come in petrochemicals. The oil glut and declining energy prices narrow the petrochemical advantage over more energy-intensive competing products, but also pull down prices of petrochemical feedstocks. Apparently persuaded that the buyer's market in oil will last, Dow just announced an agreement to sell its own oil and gas properties in the U.S. for about $400 million.

Popoff and his team are not alone in their conviction that Europe remains a sound base for well-run chemical companies. Some months ago a new contender reared up with the formation of Enoxy, a joint venture of Occidental Petroleum and ENI, the state-owned Italian oil and chemical group. That deal too has a Dow angle. The instigator, Zoltan Merszei, vice chairman of Occidental, was president of Dow Europe during the heroic growth years of the Sixties, and his stated goal is to carve out for Enoxy a Dow-sized slice of the European market. It won't be easy.

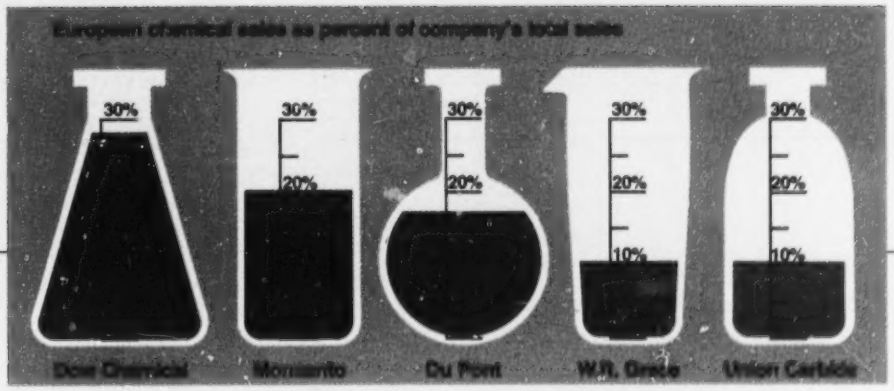
Popoff, 46, is a different type from the authoritarian Merszei. He has a breezy manner and the gift of gab. He himself offers a somewhat mysterious explanation for his casual style: "I was born in Bulgaria, so I'm naturally democratic." His father, a colonel in the Bulgarian Army before he moved to Terre Haute, Indiana, and opened a dry-cleaning business, retained business interests in Bulgaria, and it was on a trip to the old country that Frank was born. Such cosmopolitan backgrounds are not unusual in the upper reaches of Dow management. Merszei came from Hungary. Paul Oreffice, chief executive of the parent company, was born in Italy.

In a never-ending search

Dow's unorthodox strategy of making Europe a major manufacturing base and continuing to expand it aggressively when the talk in the European chemical industry is mostly of overcapacity and shrunken profits depends crucially on keeping costs competitive. Without a link to any oil company, Dow has always had to shop around for its feedstock, and the company has developed multiple sourcing to a fine art. To feed its cracking facilities in Terneuzen, Netherlands, and Tarragona, Spain, Dow Europe buys naphtha from the Total refinery near Terneuzen, but also on the Rotterdam spot market and under long-term contracts from Saudi Arabia and other supplier countries, including the Soviet Union.

In its never-ending search for economy and flexibility, the company places increasing emphasis on liquefied petroleum gas, called LPG in the trade, and on condensate. Unlike naphtha, neither is a product of oil refining. LPG, familiar to campers as bottled gas, is a natural byproduct of crude-oil output. A mixture of propane and butane gases, it can be separated and transported as a liquid. Condensate is the "wet" part of some natural-gas streams; it can be liquefied by pressure without refrigeration.

Dow has modified crackers to accept



Dow Chemical's Already in Deep in Europe

Dow leads its American peers in European chemical sales as a proportion of total corporate sales of all products. If the chart showed European chemical sales as a proportion of worldwide chemical sales alone, Dow would still be first, but W.R. Grace would rank second. The figures include relatively small amounts of sales to Africa and the Middle East—usually handled by the European branch.

these alternate feedstocks as well as naphtha, so that a plant can use whatever is cheapest. At present, with oil prices depressed, the advantage of such flexibility is not so wide, but it remains valuable insurance against rising oil prices and the rising naphtha prices that go with them. Moreover, seasonal swings favor LPG and condensate during part of the year. By its own reckoning, Dow Europe saved between $10 million and $15 million last year by running these alternate feedstocks part of the time. Dow claims to be ahead of the competition in its technology for processing liquid gases, and its deep-water coastal cracker sites provide a lasting advantage, since LPG is delivered in ships the size of aircraft carriers.

Worry about a tidal wave

Even better than being near the sea is being near a copious supply of oil or gas. In a joint venture with Sabic, Saudi Arabia's industrial arm, Dow is building a petrochemical complex at Jubail on the Gulf coast, based on ethylene output of 500,000 tons a year. A pipeline system already in place will bring in cheap feedstock: ethane gas hitherto wasted by flaring. Popoff sees the Jubail complex as part of an inevitable geographic shift of basic chemical production to where the feedstock is. "Dow has always moved to new locations," he says. "We've chased feedstock all over the world and benefited thereby. Those who stay behind are often the losers."

Exxon, Shell, and Mobil are also building petrochemical facilities in the Middle East, as are the Japanese. Some people in the chemical industry worry that a tidal wave of cheap ethylene could roll over world markets when all these plants come on stream in the second half of the Eighties. Popoff thinks the amount of disruption will depend on how the marketing is handled. Initially Dow will sell on behalf of the Saudis. Says Popoff: "We have a role to play in showing our partners that better prices can be gotten if the product is not simply unloaded onto resellers."

In manufacturing as in refining, Dow Europe puts a lot of emphasis on holding down costs. Sales per employee, a rough measure of efficiency, amount to $250,000, more than twice the median for the chemical companies on the FORTUNE 500. In his efforts to pare production costs, manufacturing boss Irving Snyder Jr. runs a fierce internal competition among his plants. Over a period of six years one stellar performer, the Styrofoam plant at Drusenheim on the French bank of the Rhine, nearly trebled output—and more than halved energy consumption per unit of output—without adding a single employee. This was done largely through a succession of design improvements in manufacturing equipment.

Styrofoam, a trademarked end-use product with sales of about $100 million a year, nice profit margins, and rapid market growth, points the way Dow Europe intends to go. For a company still regarded as mainly a producer of commodity chemicals, it has already come a long way. Pharmaceuticals, agricultural chemicals, and specialties such as Styrofoam will provide over a third of the $3.5 billion in sales expected this year. Traditional sectors like plastics and industrial chemicals, though still bigger in total, are declining in relative importance.

Popoff is fanatical about upgrading product mix. The company has dropped low-margin staples like fibers and polyvinyl chloride. Says he: "Your product has to have enough points of difference so you can price it on value to the customer rather than simply on production cost. We are trying to get into games that only a few can play." Products that Dow sees a future for include Dursban insecticide, Lontrel herbicide, the rifampicin family of antibiotics, and Dowlex, a material for making high-strength plastic film that marketing boss Thomas Sparta says "is to ordinary film as vanilla-fudge ice cream is to plain vanilla."

"All the things we make"

To sell its products, Dow Europe has 1,200 salesmen spotted in some 60 sales offices over its marketing area, which includes the Mideast and Africa. Sales in these two areas are growing 15% a year, like Europe in the golden Sixties. They now account for 10% of Dow Europe's business, and planning boss Richard Bechtold thinks they could account for 20% of a much bigger total in five years. When Henk Kila, the 43-year-old Dutchman who handles the African side, contemplates the prospects, his eyes light up. "That part of the world," he says, "needs antibiotics, insecticides and herbicides, low-cost housing materials, packaging materials—all the things we make."

One of the reasons for Dow Europe's success has been its ability to attract and keep able Europeans like Kila and weld a diverse mix of nationalities (32 at headquarters alone) into a corporate identity. Only 43 out of 13,000 employees are Americans. The 43 include the four top managers, and they remain thoroughly American in style, but that is obviously less important to the Europeans than the chance to have a lot of responsibility early in their careers and to move up fast. At the vice-presidential level, four-fifths of the executives are non-American.

The sense of autonomy extends right to

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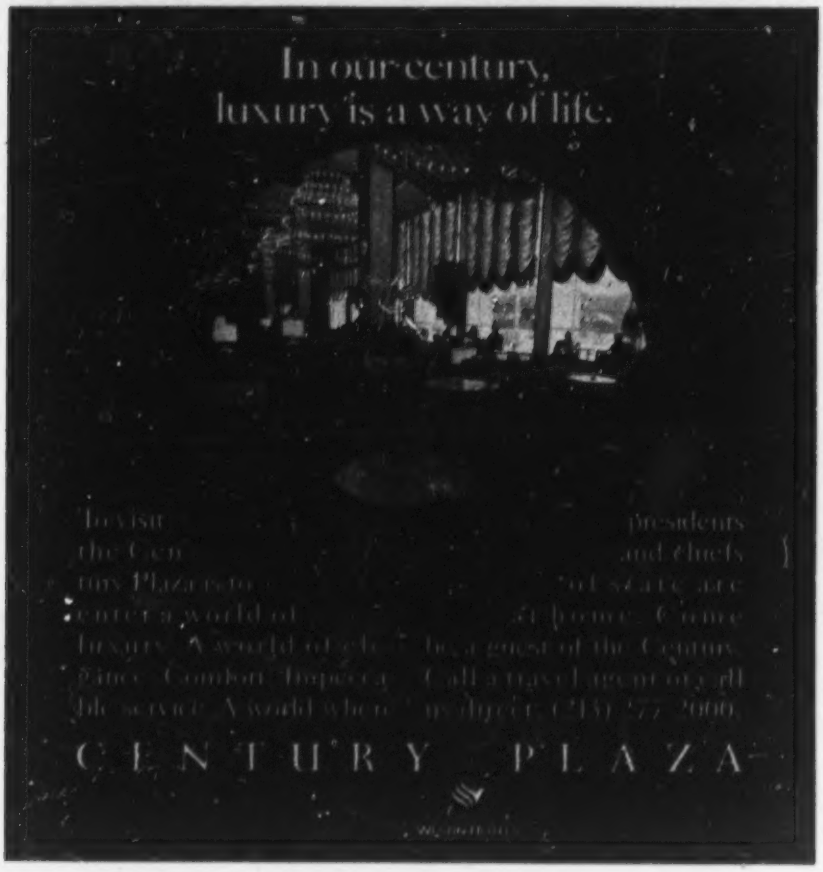


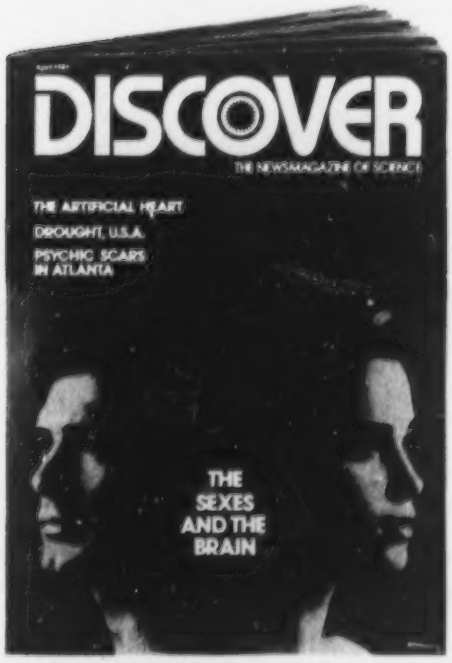
Ilse Mayer—Woodfin Camp

Frank P. Popoff, president of Dow Chemical Europe, outside his headquarters at Horgen, Switzerland, near Zurich

the top. Popoff spends a week out of every month at corporate headquarters in Midland, but not to get his marching orders. As he puts it, "If Dow Europe is to keep the autonomy it has, I have to make sure it has the resources it needs and that people know what's going on."

Popoff believes the worst is over in Europe. In his view, much of the three million or so tons of ethylene capacity now closed down will never be reopened, so capacity and demand will be much more closely matched when the recession ends. Over the long haul, he foresees growth of 3% to 4% a year for European chemical markets, nothing like the surge of the Fifties and Sixties, but enough to sustain healthy companies able to switch to more sophisticated products. Some companies, including some big ones, won't make it. In a well-publicized speech a year ago, Popoff predicted that of the world's present top 30 chemical companies, only 20 at most will survive "as we know them now" to the year 2000.

Dow intends to be part of that select company, with Europe a key element of strength. Looking beyond 1982, Dow Europe expects both sales and profits to grow by 10% a year. Back in Midland, Paul Oreffice sounds confident. "We're starting to see signs of improvement in Europe right now," he says, "and we will continue to invest and expand there. You get these bad short-term phases, but we're not in business for the short term. In the long run, Europe is a very good place for Dow to be." ■



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Science. The Great Adventure

PROFESSIONS

Profit Pressures on

by PETER W. BERNSTEIN

Not long ago, Joseph Flom and Martin Lipton were regarded as mavericks. The law firms they headed—Skadden Arps Slate Meagher & Flom and Wachtell Lipton Rosen & Katz, respectively—were considered upstarts, and the business they specialized in, corporate takeovers, was anything but respectable. Though competitors, they stuck together—and they still do, often breakfasting at New York's posh Regency Hotel to talk shop.

But with the recent proliferation of megamergers and the megafees that go with them, Flom, 56, and Lipton, 50, have become rich, famous, and respected. Each pockets at least $1 million a year. Their firms have become the most prosperous in the country, and takeover work has become the most sought-after business in the profession. Prestigious old firms that once would not have deigned to compare themselves with Skadden Arps and Wachtell Lipton are now copying them.

Thinking strategically

Law firms are hustling new business with the aggressiveness of—a Skadden Arps. Once jacks-of-all-trades, they are now specializing. More than half a dozen firms have formed groups to handle takeovers. Legal backwaters like bankruptcy work and real estate have suddenly come into the mainstream. Firms are cultivating industries apt to want more lawyering, such as banking, international finance, and high technology. To establish themselves in these fields quickly, law firms are hiring partners from rival outfits, a practice shunned in the past, and the firms themselves are merging. Amid new competition the management practices of yesteryear are yielding, and law firms have become a fertile field for management consultants with their businesslike approaches. Says James F. Rabenhorst, a Price Waterhouse partner who heads the accounting firm's law-consulting practice: "We see law firms thinking strategically now."

The impetus for change can be traced

Research associate: Philip Mattera

Prestigious old practices are scrambling into specialties they once scorned.

the Big Law Firms

Alen MacWeeney

largely to a single source: the rise of in-house counsel. Once mainly liaison between management and outside law firms, in-house lawyers are becoming powers in their own right as companies bolster their legal staffs in hopes of controlling astronomical legal bills. As a percentage of all lawyers in the country, lawyers working for corporations doubled between 1970 and 1980 to about 11%. AT&T employs 909 lawyers, some 300 more than the nation's largest law firm. General Electric's legal staff now numbers 410.

Increasingly, these in-house law staffs handle everything from routine work to litigation, once the province of outside firms. And corporations have grown choosy about giving business to outside counsel. A firm tends to get the nod these days on the basis of knowledge about a matter, not because of traditional ties. Moreover, most corporations use several firms. Says Peter A. Bator, 52, a partner at Davis Polk & Wardwell in New York: "I think we did almost all of Morgan Stanley's legal work in 1955. Today each of the investment banks uses at least half a dozen different firms."

These in-house lawyers are keeping their outside brethren on a tighter rein. Last year Control Data issued a tough new policy statement to its outside lawyers, saying that it will not normally pay for computerized legal research, staff overtime, word processing, special publications, and attendance at continuing-legal-education seminars—all items that might have been included in past bills. Out-of-town travel must be approved in advance by a Control Data attorney, as must the hiring of associate counsel, consultants, or expert witnesses. Copies of the work done

Takeover lawyers Joseph Flom (left) and Martin Lipton, the top practitioners of the country's hottest legal specialty, chat over breakfast at the Regency Hotel in Manhattan. While both have built law firms whose partners make an average of some $350,000 a year, Flom has sought maximum growth, while Lipton's firm is deliberately small with only 67 lawyers.

for the company—memoranda of law, correspondence, even drafts—must be forwarded to Control Data. Controls at Household Finance are just as stiff. Says Robert E. Bouma, the general counsel of Household International, the parent company: "Outside counsel doesn't do anything without our permission."

As in-house counsel have been flexing their muscles, the law firms' operating costs have zoomed. Computers and word-processing equipment, while making lawyers more productive, have inflicted heavy costs. Even more burdensome are the salaries being dished out to newly minted lawyers. Last year, lawyers at the big New York firms were starting at $43,000, up from $15,000 in 1968, or half again as fast as inflation. Salaries elsewhere lag somewhat, but not by much. The big Houston firms are now paying $35,000 for openers. This year the starting salary at the top New York law firms is expected to jump close to $50,000. At Wachtell Lipton, the starting wage including bonus is $55,000.

Law is still a pretty cushy line of work, at least at the top. According to a confidential and widely respected annual study by Price Waterhouse, lawyers at a dozen of New York City's largest and most prestigious firms generated an average of $184,000 each in gross fees in 1980. The firms' grosses jumped 66% over the preceding five years, and net income per partner was up by 49%. That gave partners at those New York firms a 1980 median income of $242,685—about a third more than the median of $178,700 turned up in another Price Waterhouse study of the largest firms nationwide.

But margins in the legal business are under severe pressure. According to the Price Waterhouse study, the gross fees at those 12 New York firms, adjusted for inflation, grew by only 12% over the five years ending in 1980. Meanwhile, operating expenses were climbing at almost three times that rate. A decade ago partners expected that more than half of gross revenues would end up in their pockets; now they end up with barely 36%. After discounting for inflation, net income per partner in the last five years increased by a negligible 0.7%. "There's no question that some firms have diminishing profitability," says Marty Lipton.

Profits plane at Cravath Swaine

For some firms the bad news about margins has been made worse by a recent falloff in litigation work. After years of playing second fiddle to the corporate department, litigation came to dominate many firms during the 1970s. A few years ago, when the government's antitrust trial against IBM was going full steam, IBM's trial counsel, Cravath Swaine & Moore, derived more than half its revenues from litigation. Even before that case was dismissed in January, lawyers sensed that litigation was slowing. Cravath, a New York firm, now figures that litigation will account for 45% of its fees and that profits for the next year or two will be flat. The litigation business itself may also be changing as firms specialize in different kinds of trial work. Says Davis Polk's Peter Bator: "The generalist litigators are going out of style. It is becoming a boutique business."

Such swings in the marketplace have jolted some of the most prestigious firms used to doing business the old-fashioned

continued

A Turnaround Team on Wall Street

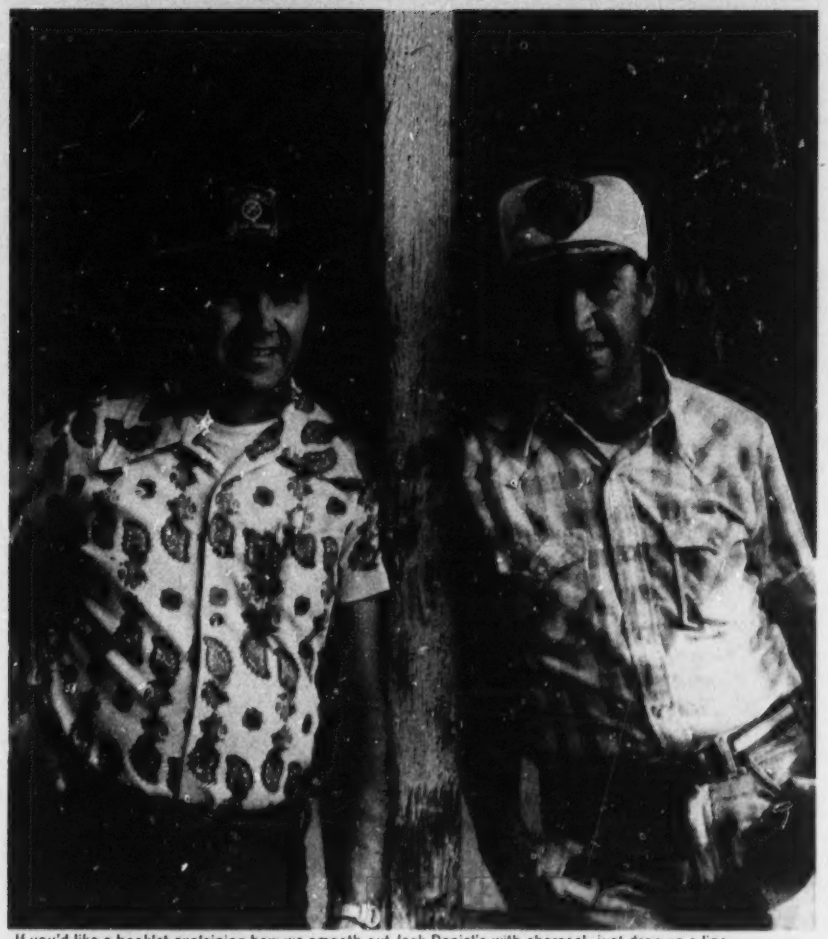
The last few years have been rough for prestigious White & Case. Slow to adapt to corporations' growing tendency to do legal work in-house, it has lost 14 lawyers since 1977. Now the firm is attempting a comeback under James B. Hurlock, 48 (center), John J. McNally, 54 (left), and Rayner M. Hamilton, 46. They plan to focus on banking, international finance, antitrust, and product liability.

Alen MacWeeney

The 25 Biggest Law Firms

Rank	Firm (number of lawyers)	City	Representative major clients	Reputation
1	**Baker & McKenzie (605)**	Chicago	Dow Chemical, Dresser Industries, Eli Lilly, Levi Strauss, Wm. Wrigley Jr.	A loose confederation of lawyers. More lawyers abroad than in the U.S. Been the biggest for a long time. Mediocre.
2	**Morgan Lewis & Bockius (353)**	Philadelphia	Consolidated Natural Gas, Penn Central, Philadelphia Electric, Philadelphia National Bank, UGI Corp.	They'd rather not be in Philadelphia—opening lots of branches and losing sleepy, old-line image. Not in the same league as the top New York firms.
3	**Shearman & Sterling (340)**	New York	Abu Dhabi National Oil Co., Citicorp, Merrill Lynch, Midland Bank, United Technologies	Very strong firm. Dominated by Citicorp and foreign-bank work. Suffers from size and excessive bureaucracy. Stuffy.
4	**Sidley & Austin (321)**	Chicago	AT&T, Burlington Northern, Commonwealth Edison, Field Enterprises, First Chicago	Uneven, especially in handling big deals. Gentlemanly. AT&T's lead counsel.
5	**Vinson & Elkins (313)**	Houston	First City Bancorp. of Texas, Quintana Group, Shell Oil, Texas Eastern Corp., Travelers	Gets a lot of mileage from John Connally. Caters to small companies; more than 8,000 active clients. Strong in oil and gas.
6	**Jones Day Reavis & Pogue (305)**	Cleveland	Diamond Shamrock, Firestone Tire & Rubber, GM, Republic Steel, Westinghouse	Top quality; the best firm in Cleveland. Especially good in antitrust.
7	**Fulbright & Jaworski (290)**	Houston	Aetna Life, Anderson Clayton, Coastal Corp., Exxon, Southwest Bancshares	A notch down from Vinson & Elkins in Houston. Strong in energy and litigation. Made too many partners too quickly.
8	**Pillsbury Madison & Sutro (282)**	San Francisco	BankAmerica, Caterpillar Tractor, Del Monte, Standard Oil of California, Tandem Computers	Good but slipping in quality. Stuffy. Relies a lot on Standard Oil of California.
9	**Gibson Dunn & Crutcher (280)**	Los Angeles	Aetna Life, Fluor, Metromedia, Rockwell International, Times Mirror	Attorney General William French Smith's firm. Uneven work. Keen on branching, especially abroad. Not on a par with top New York firms.
10	**Squire Sanders & Dempsey (277)**	Cleveland	Cleveland Electric Illuminating, Harris Corp., NCAA, Standard Oil (Ohio), U.S. Steel	A clear second to Jones Day in Cleveland. Built practice on municipal-bond work. Good Washington office.
11	**Skadden Arps Slate Meagher & Flom (275)**	New York	Anheuser-Busch, Champion International, CSX, Daimler-Benz, Sir James Goldsmith interests	Street-smart and aggressive. Excels only in the takeover area. Joe Flom dominates the firm. Even partners work like coolies.
12	**Kirkland & Ellis (262)**	Chicago	GM, International Harvester, Skidmore Owings & Merrill, Standard Oil (Indiana), Weyerhaeuser	The Establishment firm in Chicago. Strong in litigation. Lost 15 lawyers and some big clients when ousted partner Don Reuben started a rival firm.
13	**O'Melveny & Myers (251)**	Los Angeles	Carter Hawley Hale Stores, IBM, Lockheed, Occidental Petroleum, Security Pacific	Good but not among the best. Slipped in the last ten years. Known for high fees.
14	**Davis Polk & Wardwell (242)**	New York	International Paper, McDermott, Morgan Guaranty, Morgan Stanley, Richardson-Vicks	Excellent and well rounded, with outstanding corporate department. Patrician.
15	**Paul Weiss Rifkind Wharton & Garrison (239)**	New York	Chris-Craft, Continental Grain, N.Y. Municipal Assistance Corp., Revlon, Warner Communications	One of the best. Hard-nosed litigators. Not as strong in corporate. Politically well connected.
16	**Mayer Brown & Platt (235)**	Chicago	Brunswick, Continental Illinois, Dome Petroleum, Esmark, Northern Illinois Gas	Dependent on Continental Illinois. Weak spot is litigation. Improving.
16	**Weil Gotshal & Manges (235)**	New York	General Electric Credit Corp., Matsushita Electric, Oppenheimer & Co., J.C. Penney, Sotheby Parke Bernet	Strong antitrust, bankruptcy, and real-estate practices. Not first-rate in other areas. Low morale, domineering management.
18	**Finley Kumble Wagner Heine Underberg & Casey (234)**	New York	American Bakeries, City Investing, Giant Food, Motown Records, Occidental Petroleum	Fastest-growing large firm. Not in the big leagues but trying to get there. Politically well connected.
19	**Simpson Thacher & Bartlett (231)**	New York	American Electric Power, Gulf & Western Industries, Lehman Bros. Kuhn Loeb, Manufacturers Hanover Trust, Seagram	Excellent, with particularly strong corporate department. Not aggressive in seeking new clients. High morale. Cy Vance presides.
20	**Baker & Botts (227)**	Houston	Gerald D. Hines interests, Pennzoil, Schlumberger, Tenneco, Zapata	The Houston firm with strongest corporate practice. Formal, very conservative.
21	**Baker & Hostetler (225)**	Cleveland	Avis, Cleveland Clinic, Frontier Airlines, PPG Industries, Scripps-Howard	The No. 3 firm in Cleveland. Excels in First Amendment work, lots of publishing clients.
21	**Fried Frank Harris Shriver & Jacobson (225)**	New York	Connecticut General Life, Goldman Sachs, Humana, Rio Tinto-Zinc, Royal Trust	A hot firm. Good in securities work and takeovers. As strong in Washington as in New York. Strong Democratic party connections.
21	**Milbank Tweed Hadley & McCloy (225)**	New York	Alcan Aluminium, Amerada Hess, Chase Manhattan, Columbia Pictures Industries, Mobil	Strong in banking. Stilted and lacking in imagination. May be slipping. Leader in use of computer technology. The Rockefeller family's firm.
24	**Coudert Brothers (222)**	New York	Bendix, Ford Motor, Nippon Electric, Sumitomo Bank, Thiokol	Not top-rate. Recently warded off a partners' revolt, but problems remain. Strong international practice. Has grown erratically.
25	**Covington & Burling (221)**	Washington	Du Pont, Exxon, IBM, Union Pacific, Upjohn	The leader in Washington. Versatile and talented lawyers. Patrician.

This list ranks the 25 biggest law firms on the basis of how many lawyers they employ rather than the revenues they take in, because the firms, as private partnerships, do not publish financial data. FORTUNE *estimates that these 25 firms each gross between $35 million and $90 million a year, and that their profitability, which is affected by the ratio of partners to associates, varies equally widely. (Generally, the more associates per partner, the more profitable the firm.) The firms also do not usually disclose their clients, but at* FORTUNE*'s request most named five representative major clients. The sketches of the firms' reputations are based on interviews with more than 60 lawyers. The comments reflect the consensus; the words used are the lawyers' own. Though the sample was nationwide, the views suggest a New York bias–perhaps because historically New York has tended to set standards in the law business.*



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way. Wall Street lawyers often single out Sullivan & Cromwell as a firm that has been late in reacting to change. "They didn't realize they had almost lost Goldman Sachs, First Boston, and Lazard Frères as clients," says a competitor. Sullivan & Cromwell's George C. Kern Jr. virtually concedes the point: "We went into the takeover business because we were concerned that the bankers would take their business elsewhere."

White & Case, which employs 7% fewer lawyers than in 1977, is having an even rougher time adjusting. "It's the No. 1 example of a firm whose client base was skewed to old-line manufacturing companies that now do most of their work inside," says a competitor explaining the firm's decline. The most visible and sudden jolt came when Seagram, a longtime client, took its business down the street to Simpson Thacher & Bartlett. When the *American Lawyer*, a trade magazine, ranked 169 firms in terms of growth last year, White & Case placed last.

New firms are also vulnerable. Kutak Rock & Huie, an Omaha firm specializing in tax-exempt finance, which had grown spectacularly during its 16-year life, fired 30 lawyers last fall. Says Robert J. Kutak, 49: "We decided to resize ourselves." There are 186 lawyers left.

Won't do wills

In this tough new environment, firms have been scrambling to get rid of unprofitable lines of business. Over the last five years, as casualty-insurance companies have clamped down on legal fees, Houston's Baker & Botts has been representing fewer of them in damage suits. "That business was no longer profitable," says managing partner William C. Harvin, 62.

For some firms the pruning effort has been an education. "The truth is we don't know what is profitable," confessed one partner at a Wall Street firm that has invested heavily in office-management systems. "We're working on that."

Trusts and estates work, traditionally a standard service of corporate-law firms, is coming under new scrutiny. Drafting wills

continued

Joe Flom's Marvelous Money Machine

For most of the past decade the reddest, hottest red-hot law firm in the U.S. has been Skadden Arps Slate Meagher & Flom, which hitched its wagon to a star named Joseph H. Flom and rode to fame and fortune. Skadden Arps now ranks 11th in terms of number of lawyers employed and is one of the fastest-growing law firms in the country. FORTUNE estimates that the firm grossed about $65 million last year and that its 74 partners probably pulled down an average of close to $350,000 apiece.

Founded in 1948, the firm took off after a long, slow start. "The first two years I was on salary, I made more than all the partners combined," recalls Flom, who was hired as the firm's first associate right out of law school. By 1970 the firm still employed only 40 lawyers, but Flom had a growing reputation as an aggressive proxy-fight lawyer. When a number of corporations started making hostile tender offers for other companies in the early 1970s, they came to Flom for advice. As the number of deals exploded, so did Skadden Arps. Lawyers at the firm figure they are involved in 80% of the big deals made today.

Such dominance is a testament both to Flom's keen legal mind and his tactical skills. Brooklyn-bred and educated at New York's City College and Harvard Law School, he is an unprepossessing man with a genius for crafty arguments. He once argued that a dental-supply company whose customers included many Jewish dentists would lose business if a company partly owned by some Kuwaiti investors took it over. Whether it was that argument, and its implication that the fighting could get nasty, or Flom's success in recruiting a white knight to make a competing offer, the company backed off. While often taciturn and ill at ease personally, he shines when plotting strategy with clients.

A Bloomingdale's of law

Flom is a peculiar leader. Though he says, "I want to build an institution," he eschews managing the firm, even skipping out on partnership meetings. Yet his absence doesn't signify indifference; nothing is done without his consent.

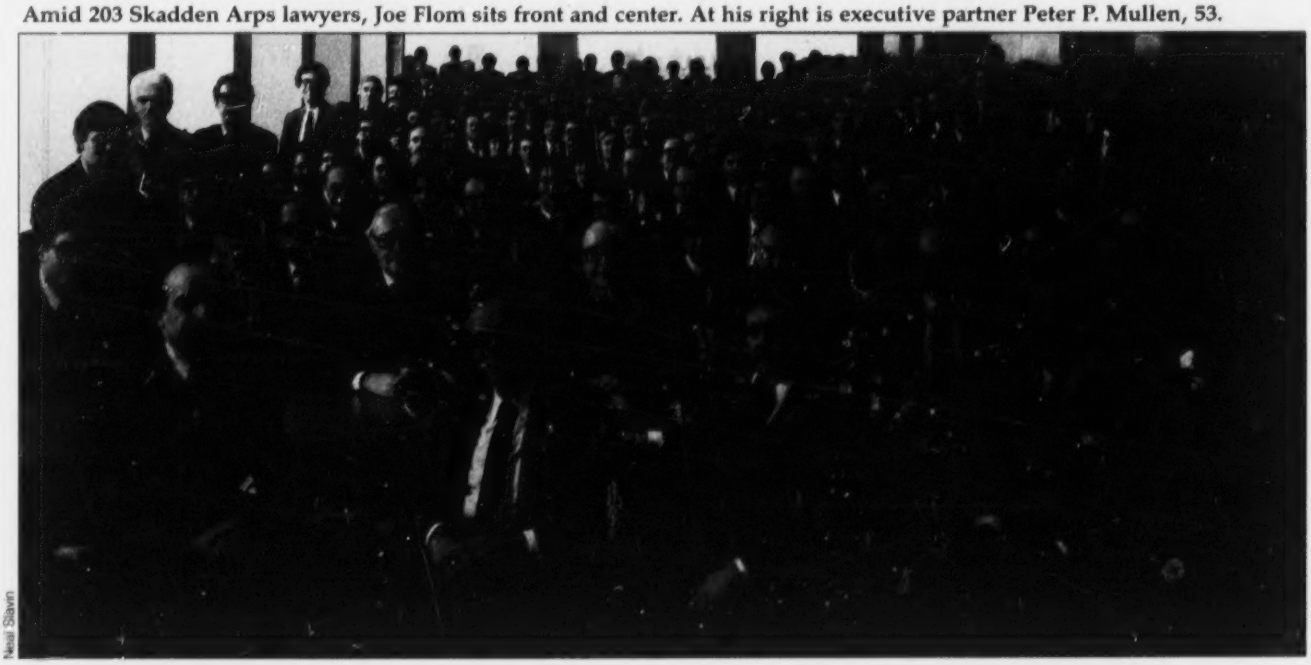
Flom's aim is to create the Bloomingdale's of the law business—a group of specialty boutiques all under one shingle. "Our strategy," explains Peter P. Mullen, 53, the firm's executive partner, "is to take the preeminence we achieved in the tender-offer business and use it to develop other areas." The firm investigated 27 different fields of law before deciding to concentrate on bankruptcy, real estate, environment, and energy in addition to the antitrust, corporate, litigation, tax, and labor practices it already has.

To establish itself in these new areas, Skadden Arps has been hiring top legal talent from all over. It signed up a New York University law professor to start its product-liability practice in 1979. A year later it recruited a specialist in bankruptcy law from Weil Gotshal & Manges. Its most dramatic move came last year when it corralled Lynn R. Coleman, 42, Deputy Secretary of Energy in the Carter Administration, to begin an energy practice. The firm has also signed up a notable nonspecialist: Irving S. Shapiro, 65, the former chairman of Du Pont, who practices out of Wilmington.

Such diversification has already produced results. Mullen claims that takeover work now accounts for about one-fifth of the firm's business, down from about 40% five years ago. But the energy practice has been a disappointment, and the non-takeover business has been bumpy. "These guys are so geared up for crises that ordinary matters get left in the dust," complains a dissatisfied customer.

And after Flom? "If Joe was hit by a truck, the firm would suffer a glitch and then pick itself up and go on," says a colleague. In fact, it's too soon to tell whether Skadden Arps will become the institution Flom wants it to be. But his own reputation is established. As one competitor puts it: "He is the greatest legal entrepreneur of the century."

Amid 203 Skadden Arps lawyers, Joe Flom sits front and center. At his right is executive partner Peter P. Mullen, 53.



Neal Slavin

These boxes in storage in Rotterdam, New York, contain some of the 7.8 billion pages of documents that a federal court ordered IBM to save during the antitrust case the government dropped in January. The recent falloff in litigation and the government's new reluctance to bring some kinds of large antitrust cases make it unlikely that so vast a collection of materials will be amassed again.

can be extremely lucrative when it paves a lawyer's way into the promised land of executor fees. But in practice it is often offered primarily as a convenience for executives of big corporate clients. Says William C. Cobb, a Houston-based consultant who has worked for quite a few of the 200 largest law firms: "For many, trusts and estates is a loss leader."

Legal life after death

But mainly the law firms are plunging headlong into lucrative new specialties. Once dismissed as "unseemly, grubby undertaker's work," in the words of a partner at Milbank Tweed Hadley & McCloy, bankruptcy work has gained a new fascination as lawyers discover that there can be life after death—for example, when a bankrupt client such as Penn Central emerges as a dynamic new corporation and client. Another long-neglected area suddenly prominent is real estate. Weil Gotshal & Manges's real-estate department, which had six lawyers in 1979, now has 32. Some of this growth is explained by the presence of a new partner brought in to stimulate the practice, but, as senior partner R. Todd Lang, 57, points out, the practice has also gained "an institutional aspect." One example: the recent $500-million deal for the General Motors Building in New York. Weil Gotshal, whose offices are in the building, represented GM, which under the complicated transaction will eventually sell the building.

Some firms' search for legal gold has a speculative aura. Sullivan & Cromwell is going after commercial banking on the theory that interstate banking will come, and with it a wave of bank mergers. A group to handle bank mergers has already been set up. Says one partner: "Banks from all over the world are coming in to see us." In contrast, White & Case is focusing on international finance. Its clients already include the central banks in Costa Rica, Gabon, Indonesia, Turkey, and Zaire. Gibson Dunn & Crutcher, a Los Angeles firm, takes a more California-oriented approach, turning its attention to the emerging companies of Silicon Valley in the belief that these fast-growing enterprises will have spent less time developing in-house legal capabilities and therefore will lean more heavily on outside counsel.

Whatever new practice areas lawyers dream up, it's doubtful that they will ever strike a bonanza as big as takeover work. Traditionally lawyers have charged clients on the basis of time, with six minutes now a standard billing unit. But merger and acquisition work commands a premium. For openers the top firms charge a serious minimum fee. At Wachtell Lipton it can be $50,000 to $100,000; for about $75,000 a year clients can retain Skadden Arps. The down payment ensures the client a crack at Skadden Arps' services should it become involved in a takeover brawl. In the case of conflict between two clients, the firm usually chooses to represent the company under attack. More than 200 companies have anted up for "the Joe Flom protection policy," as one lawyer dubs it.

Flom defends what he claims, probably correctly, is an age-old practice. If the money isn't used in a takeover matter, he notes, the client is free to apply it to other services provided by the firm. As for those who criticize his retainers: "They're just jealous because I have it and they don't."

Once a takeover fight begins, all firms charge higher-than-usual rates. According to its formal billing policy, one firm specializing in takeovers bases its charges in part on "the responsibility assumed and the result achieved." That means "not less than 200% and sometimes more than 300% of base time charges." Rough translation: $400 to $600-plus per hour per lawyer. In the Mobil-Marathon-U.S. Steel struggle, the dozen or so law firms involved—including Donovan Leisure Newton & Irvine, Jones Day Reavis & Pogue, and White & Case, lead counsel for the three companies respectively— had fees of more than $10 million.

With that kind of money available, firms are foraging ravenously for takeover work. Shearman & Sterling has 30 lawyers assigned to its tender-offer group. A fifth of Sullivan & Cromwell's revenues comes from takeover work. Fried Frank Harris Shriver & Jacobson derives a "significant" part of its fees from takeover business. The lawyers involved are fiercely competitive. Crows one in an unguarded moment: "We've had a remarkable string of successes against Skadden Arps."

Takeover work has another advantage: "It's a big new-business-getter," says George Kern, 56, the lawyer at Sullivan & Cromwell who runs its merger and acquisition department. A third of the firm's M&A work comes from new clients. Besides, Kern says, clients who come in for takeover work end up using the firm for unrelated matters.

Lateral hiring

Has the merger wave crested? "Quite the contrary," says Joe Flom. The depressed economy and the permissive regulatory climate should spur more big deals. Adds Flom: "Bargains abound."

Since it isn't easy to become an instant expert, law firms are hiring established specialists—something they frowned on in the past. Traditionally the partners of the big firms have been homegrown, with exceptions made only for an occasional former high-ranking government official or distinguished judge. Today lateral hir-

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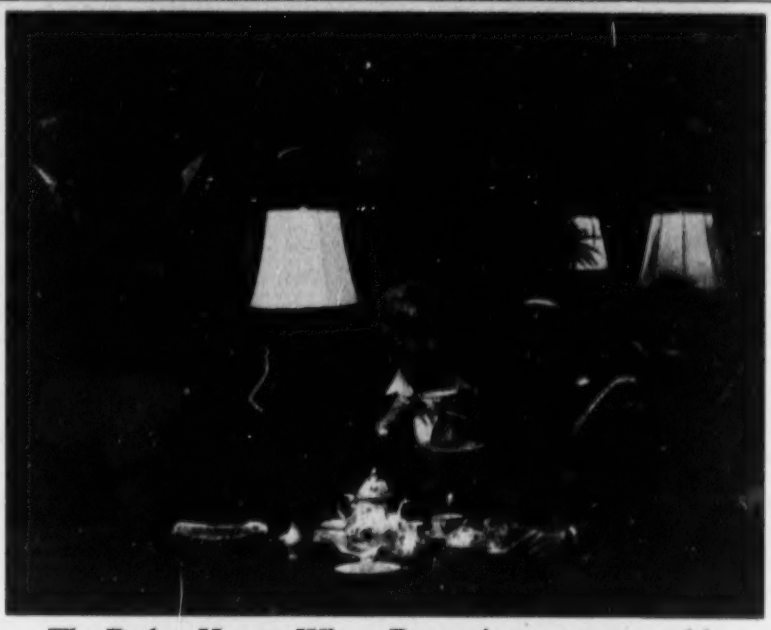

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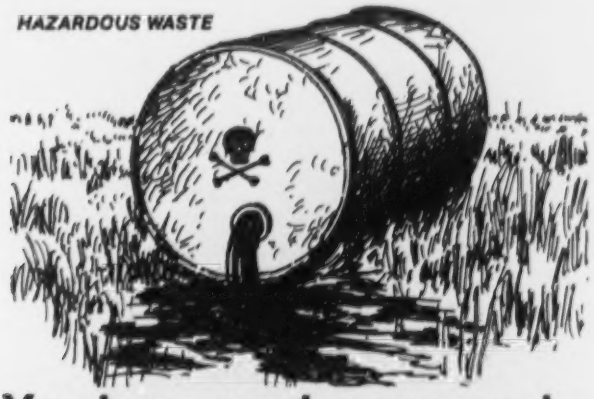

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When Jerome Alan Cohen, 51, a Harvard professor and renowned Asian legal scholar, decided to leave Coudert Brothers, he talked to at least three other firms—Skadden Arps, Cleary Gottlieb Steen & Hamilton, and Paul Weiss Rifkind Wharton & Garrison. In the end Cohen signed with Paul Weiss, which guaranteed him about $300,000 in the first year. It will be a while before Paul Weiss knows if the gamble pays off, but thanks to Cohen the firm now is doing business in Peking even though foreign lawyers are technically not allowed to practice in China.

No goodbyes to Columbus

As long as you're hiring an outside partner, why not absorb an entire firm? The bigger firm gains new expertise and clients, and the smaller firm is able to spread its overhead over a broader base while gaining new business. Exploiting that logic, Finley Kumble Wagner Heine Underberg & Casey has become the fastest-growing large firm in the country. Founded in New York in 1968 with six partners and three associates, it now has 234 attorneys in six offices throughout the U.S. Along the way it absorbed a small bankruptcy firm, a Washington, D.C., firm with a strong government-relations practice, and a few others. It has also taken on as partners political heavyweights like former New York Mayor Robert Wagner and ex-Senator Joseph Tydings of Maryland.

Law firms are also striking out geographically. In the past, firms have opened new branches mainly to give an existing client better service; for example, the only reason Simpson Thacher & Bartlett has an office in Columbus, Ohio, is to cater to the needs of client American Electric Power. Now firms are settling in new spots whether they have a client there or not. Sidley & Austin, a Chicago firm, started an office in Los Angeles because "it is one of the primary financial centers of the nation." Morgan Lewis & Bockius, the nation's second-largest firm, with seven of-

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EASTERN

Washington, D.C., may be a disaster area.

offices, says it thinks of itself not as a Philadelphia law firm, heaven forbid, but as a national law firm whose headquarters happen to be in Philadelphia.

The presence of all these new lawyers and offices subjects law firms to new strains. Branch offices have often been unsuccessful. Cravath recently decided to close its 18-year-old Paris office. "From an economic point of view, we should have closed both London and Paris years ago," says managing partner Samuel C. Butler, 52. One impending disaster area may be Washington, D.C., where almost all the big firms have opened offices. The sluggish regulatory scene has already caused one firm to close its branch. Even established Washington firms are finding business slow. "They're politely calling New York firms and offering to help out on matters," reports a partner at one Wall Street firm. It's no accident that the firms that have been most aggressive about opening branch offices are in depressed industrial cities like Philadelphia and Cleveland. Success, of course, has its own perils. Lawyers in a booming branch office are tempted to break off on their own and keep all the money for themselves.

Partnership isn't forever

As firms get bigger, the strains are sure to continue. Partnership used to be for life, but it is no longer. In a dispute over how to divide the spoils, 12 lawyers left New York's Kaye Scholer Fierman Hays & Handler three years ago to form their own firm. Dissatisfied with the performance of some of its partners, Willkie Farr & Gallagher of New York has asked about a half dozen to leave over the last few years.

Law firms can still continue to grow. But the fruits of success will not rain down upon all the firms as equally as in the past. Says Bruce D. Heintz, a law-firm consultant at the accounting firm of Arthur Young: "In the 1980s the bigger, stronger, more aggressive firms will steal from the weaker ones." That Darwinian message is a further piece of good news for Joe Flom, Marty Lipton, and all those following in their footsteps.